Azerbaijan Economy

From public to private

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Azerbaijan's recently published draft budget indicates that the country will continue to consolidate its fiscal policy in 2017 by reining in current expenditures while cutting public investment. The revenue projections in the document are based on an oil price of US$ 40.0/bbl and 1.0% GDP growth. This assumption appears realistic, given the current trend in oil prices, and we see minor upside. The growth rate in non-oil sectors might be lower than forecast, though this will probably be compensated for by better-than-forecast performance in the oil sectors. Downside risks to the targeted non-oil GDP growth may be eliminated if private investment increases, specifically from abroad since foreign investment, has a higher efficiency in generating growth and financing the external deficit,. There is theoretical upside, subject to policies that attract investors, particularly in light of the stock of foreign investment in non-oil sectors.

GDP to grow at low single-digit levels

The draft budget projects Azerbaijan's economy to grow 1.0% y/y in 2017 and 1.5% y/y in 2018. In nominal AZN terms, GDP is expected to reach AZN 61.4bn, up 13.0% compared to the actual 2015 GDP figure. In US$ terms, however, GDP is projected at US$ 38.4bn, almost half of the record high of US$ 75.2bn reached in 2014. Our calculations indicate that these figures are realistic, with upside driven by the oil sector, while the non-oil sectors look likely to face serious challenges, particularly given the cuts to public capex.

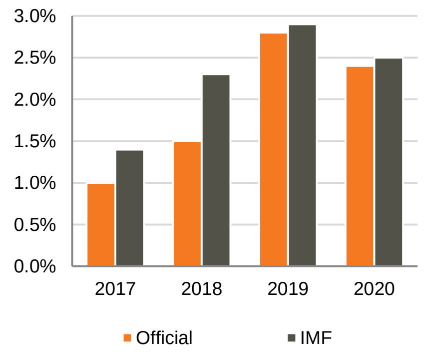
Fiscal deficit to narrow

The government has announced a conservative 2017 budget, based on an oil price assumption of US$ 40/bbl. The document projects consolidated budget revenues of AZN 19.7bn, 8.6% higher than actual 2015 revenues (see note on the second page). Revenues for 2017 are projected at 32.1% of GDP, less than the historical average, suggesting upside potential. The government plans to spend AZN 21.0bn in 2017, which is 0.5% less than actual 2015 budget expenditures. As a result, the consolidated budget deficit is set at AZN 1.2bn, or 2.0% of GDP, compared to the actual 5.3% figure seen in 2015. Given that there is revenue upside and a likelihood that the government will underspend, there is a possibility that fiscal balance might even be achieved.

Preference given to medium- to long-term fiscal sustainability

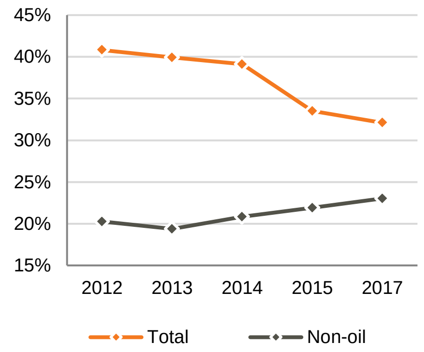
Expenditures are to be decreased by reducing public capital investments. The draft budget puts capex from the state budget at AZN 3.7bn, which is 45.6% less than actual public capex in 2015. The cut is even more pronounced in US$ terms, with capex budgeted at US$ 2.3bn in 2017 compared to US$ 6.5bn (actual) in 2015. With overall expenditure down, transfers from the State Oil Fund (SOFAZ) are to be decreased to AZN 6.1bn, which is 19.9% lower than the transfers set in the 2016 budget and almost half of the level transferred in 2013. Moreover, excluding transfers, SOFAZ expenditures are to come down to AZN 0.9bn, which is 17.3% less than in 2015. Current expenditure, however, is budgeted almost flat compared to the 2016 budget and 7.8% more than the 2015 actual figure. These figures suggest that the government is committed to medium- to long-term fiscal sustainability. This policy will likely cause debt/GDP to remain low and SOFAZ reserves to last longer. The flipside is the challenges likely to be faced by the economy given the cuts to public capex.

Figure 1: GDP growth rate, y/y %



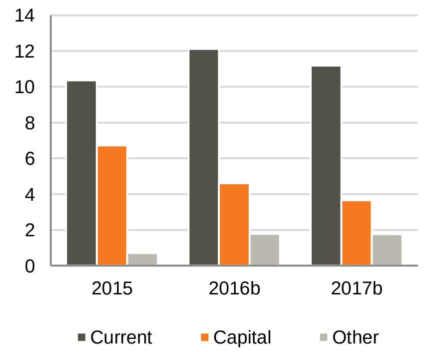
Source: Ministry of Finance, IMF

Figure 2: Consolidated budget revenue, % of GDP



Source: Ministry of Finance
Note: Non-oil revenue % of non-oil GDP

Figure 3: State budget expenditure, AZN bn



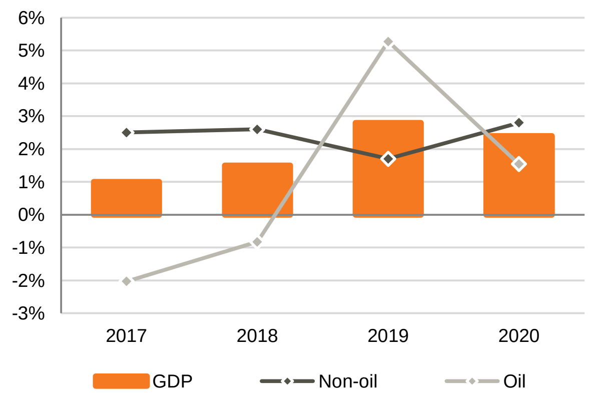
Source: AzSTAT

Alim Hasanov
Economist | ahasanov@gt.ge | +995 322 401 111 ext.3933

2017 draft budget summary

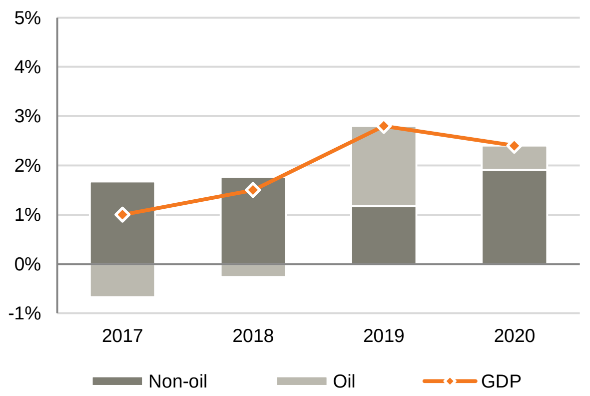
Government expects subdued growth. The official draft budget for 2017 has growth in 2017-20 being based mainly on non-oil sectors. The government expects growth to be subdued in 2017 (1.0%) and 2018 (1.5%), due to a contraction in oil GDP. The oil sector is expected to post relatively strong growth in 2019 (due largely to the commencement of Shah Deniz stage 2), helping the overall economy to grow by 2.8%. However, as the boost from the oil sector retreats, GDP growth is forecast to slow to 2.4% in 2020.

Figure 4: GDP change, %



Source: Ministry of Finance, Galt &Taggart Research

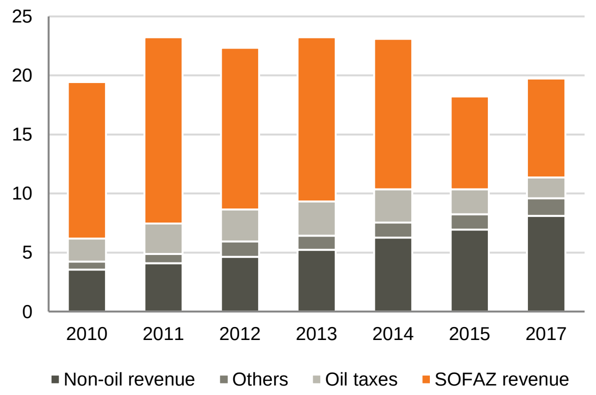
Figure 5: Contributions to growth, %



Source: Ministry of Finance, Galt &Taggart Research

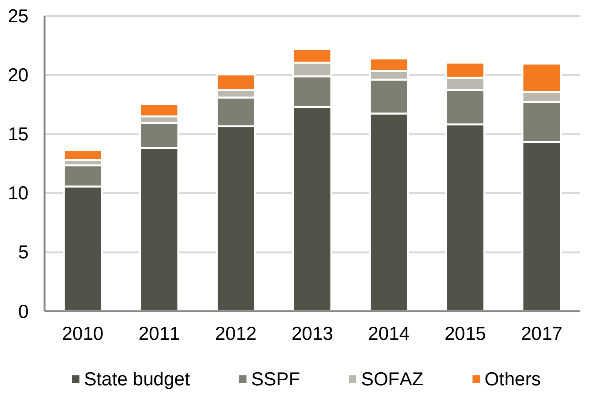
2017 budgeted public revenues realistic, with upside potential. The 2017 draft budget is based on an oil price of US$ 40.0/bbl, which yields consolidated budget revenues of AZN 19.7bn, or 8.3% more than actual revenues in 2015. Receipts are set to be driven by a 16.8% increase in non-oil revenues and a 6.5% increase in SOFAZ revenues, while oil taxes are expected to decrease 16.0% compared to the 2015 actual figures.[1] There is upside potential, as oil prices might be slightly higher than the budgeted US$ 40.0/bbl and the government may boost non-oil revenues through various efficiency-enhancing steps. Thus, on the revenue side, upside is larger than downside.

Figure 6: Consolidated budget revenues, AZN bn



Source: Ministry of Finance, Galt &Taggart Research

Figure 7: Consolidated budget expenditures, AZN bn



Source: Ministry of Finance, Galt &Taggart Research
Note: transfers have been eliminated to obtain categories to sum up to total expenditure

[1] *2016 has been omitted as the budget was revised early in 2016 based on an oil price of US$ 25.0/bbl, but the average oil price was US$ 43.0/bbl in 9M16, meaning that actual budget revenues should be far higher than budgeted. Moreover, official data indicate that the government has been underspending. Thus, there is a high probability that actual 2016 figures will be significantly different from the budgeted ones, so comparing the 2017 budget with the 2016 one might be misleading.*

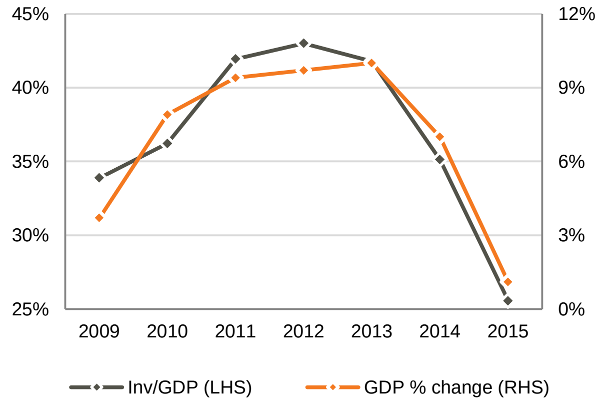
Budgeted public capex 45.6% lower than the 2015 actual figure. Expenditures in 2017 are set at AZN 21.0bn or 0.5% less than in 2015. Excluding transfers to the State Social Protection Fund and Nakhchivan Autonomous Republic, state budget expenditure is slated at AZN 14.3bn or 9.4% less than in 2015. The government plans capital investment of AZN 3.7bn, which is 45.6% less than in 2015, while current expenditures are set to be AZN 11.2bn, or 7.8% more than in 2015.

Consolidated budget deficit at 2.0% of GDP. With revenues of AZN 19.7bn and expenditure at AZN 21.0bn, the consolidated budget deficit should be AZN 1.2bn, or 2.0% of GDP, compared to a deficit of 5.3% of GDP in 2015. However, the deficit could be even lower if the oil price rebounds and the budget is further underspent.

Growth and investment

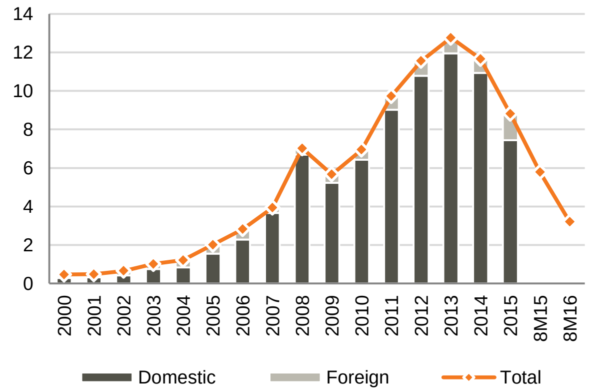
Growth driven by investment. Growth is generally driven by investment, particularly in developing economies. Azerbaijan's non-oil GDP posted annual growth rates above 9.0% from 2011 to 2013, thanks to investments of above 40.0% of non-oil GDP. As investment started to retreat, so did non-oil GDP. However, official data indicate that most of the non-oil investment was public capex, with the share of foreign investment negligible. Public capex in AZN terms was already down 16.7% y/y in 8M16, while domestic private investment was down 71.5% y/y, based on our calculations. The result has been a 5.8% y/y contraction in non-oil GDP.

Figure 8: Non-oil investment and growth



Source: AzSTAT

Figure 9: Non-oil investment, AZN bn



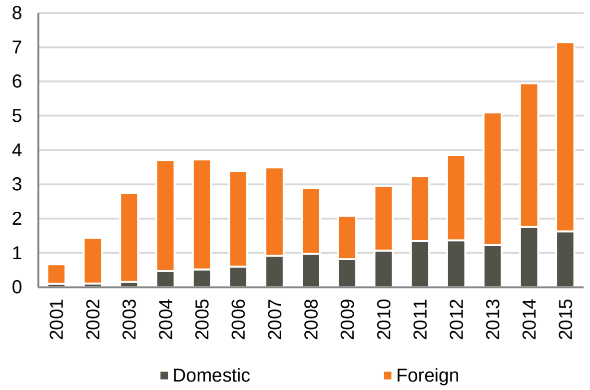
Source: AzSTAT, Galt &Taggart Research

Around US$ 3.0bn of private investment would be needed to achieve targeted 2.5% y/y growth in non-oil GDP in 2017. Simple calculations indicate that if state investment contracts 45.0% in 2017 (compared to 2015), there will be a need for US$ 3-5bn of private sector investment in non-oil sectors to support the officially expected 2.5% y/y growth of non-oil GDP. Given the state of the domestic entities and the problems faced by the banking system, such high domestic investment seems unlikely. The most viable option would be to attract foreign investment. Assuming that private foreign investment will be more efficient, and using the low base of 2016, the targeted growth might be achieved even with less than US$ 3.0bn. However, to attract this investment, foreign-investment-friendly reforms would need to be implemented. Along with driving growth, foreign investment will finance the external deficit, thereby lessening the need to curb imports.

Excluding mining and quarrying, foreign investment's share in the economy has been minor. The charts below indicate how foreign investment in Azerbaijan has focused on oil and gas extraction. On average, 82.9% of all foreign investment per annum from 2001 to 2015 was in mining and quarrying (including oil and gas extraction) and 75.9% of total investment in mining came from overseas. Meanwhile, the share of foreign investment in other sectors was below 20.0%, with the exception of the "other industry" category, which includes electricity generation. For example, the share of foreign investment was at 2.9%, in trade and 7.7% in hotels and restaurants. These low shares may well make these sectors attractive to foreign investors.

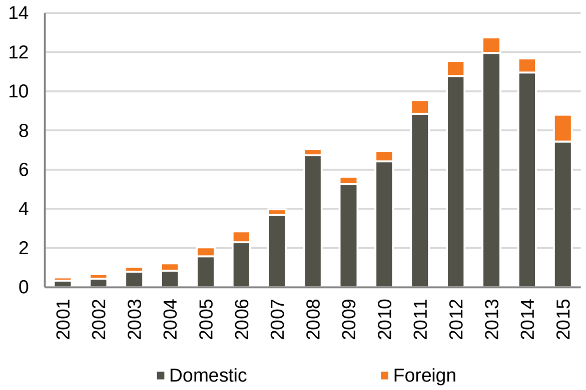
Investment in sectors of economy by source

Figure 10: Mining & quarrying, AZN bn



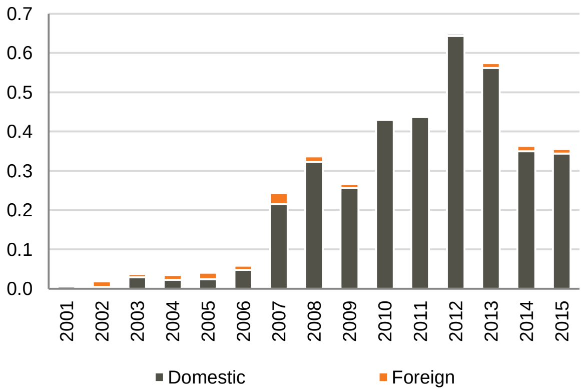
Source: AzSTAT

Figure 11: Non-mining, AZN bn



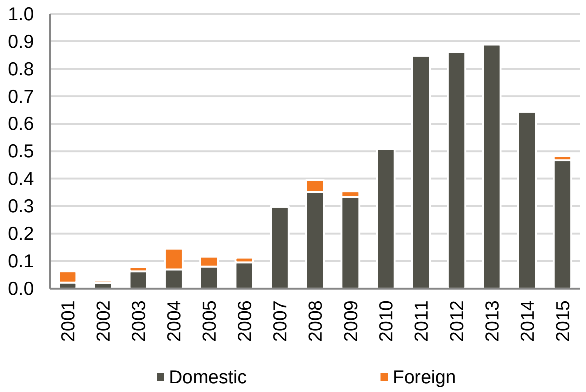
Source: AzSTAT

Figure 12: Agriculture, AZN bn



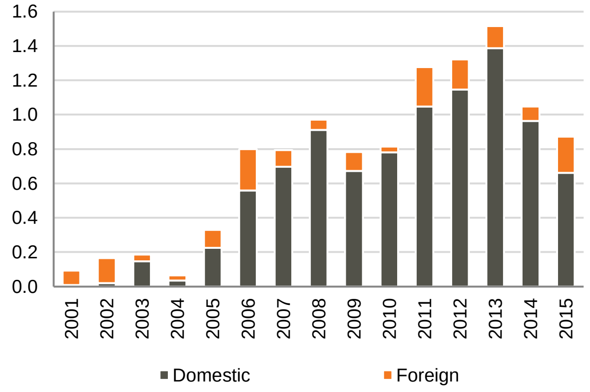
Source: AzSTAT

Figure 13: Manufacturing, AZN bn



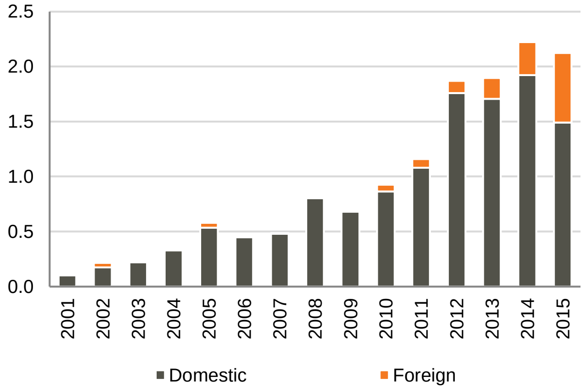
Source: AzSTAT

Figure 14: Other industry, AZN bn



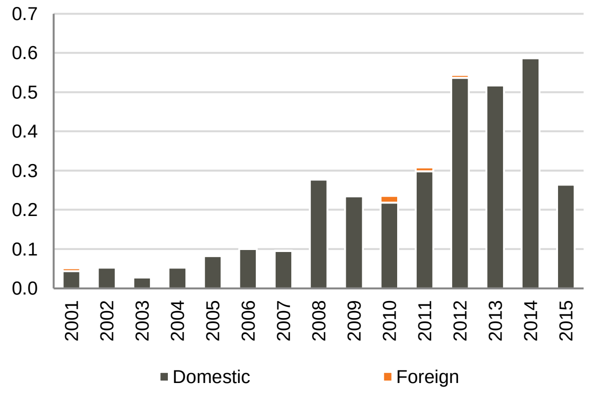
Source: AzSTAT

Figure 15: Construction, AZN bn



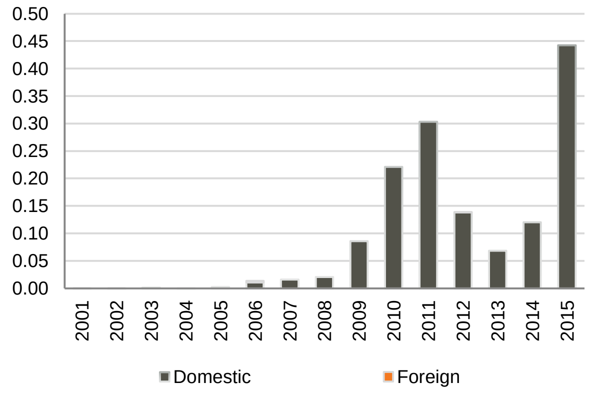
Source: AzSTAT

Figure 16: Trade, AZN bn



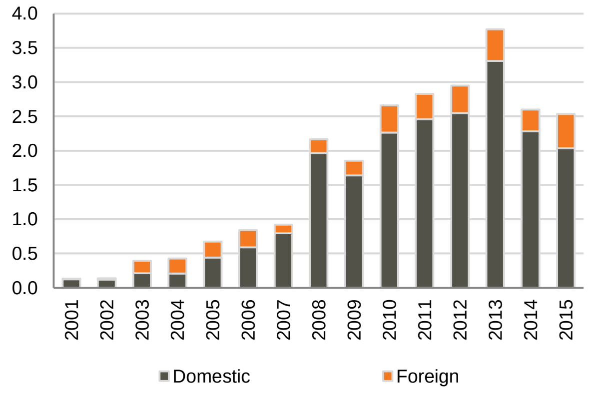
Source: AzSTAT

Figure 17: Hotels and restaurants, AZN bn



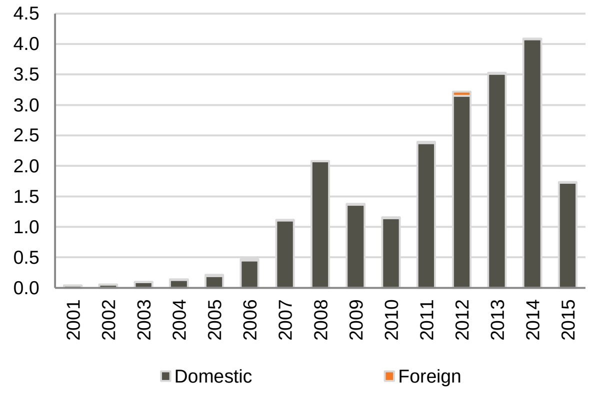
Source: AzSTAT

Figure 18: Transport, storage, communication (AZN bn)



Source: AzSTAT

Figure 19: Other sectors, AZN bn



Source: AzSTAT

Conclusion

Azerbaijan's budget for 2017 is based on figures that we consider realistic, with upside potential on the revenue side. Revenues may be higher than budgeted if the oil price exceeds the US$ 40.0/bbl set in the draft budget and efficiency gains are achieved in tax collection. On the expenditure side, authorities remain committed to keeping current expenditures intact, while cutting capex, indicating a preference for medium- to long-term fiscal sustainability. However, doing so would pose serious challenges to growth for the next few years, as the economy has been driven by public investment for the last decade. Quick calculations indicate that actual growth might be less than targeted by the authorities if the reduced public investment is not substituted by private investment. As private investment is more efficient, targeted growth might be achieved with less private investment than public investment. Securing foreign investment would mean having sustainable financing for the external deficit without undermining imports (and thereby living standards). Overall, we believe that the draft budget looks realistic and should serve long-term fiscal sustainability. However, failure to attract private investment may translate into meager growth and persistent external imbalances. Alternatively, the budget may be revised to increase spending. This, however, could endanger medium- to long-term fiscal sustainability, put Azerbaijan's sovereign ratings at risk, result in rapid depletion of reserves, and lead to inflationary pressure.

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Economist
Eva Bochorishvili | evabochorishvili@gt.ge

Economist
Alim Hasanov | ahasanov@gt.ge

Senior Associate
Giorgi Iremashvili | giremashvili@gt.ge

Analyst
David Kutidze | dkutidze@gt.ge

Address: 79 D. Agmashenebeli Avenue, Tbilisi 0102, Georgia
Tel: + (995) 32 2401111
Email: research@gt.ge